DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER 97-0477
STATE GROSS INCOME TAX
For Years 1992, 1993, 1994, and 1995

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on the date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Whether Taxpayer is a Manufacturer Entitled to Claim Exemption From the Gross Income Tax Under the Interstate Commerce Clause.

Authority: U.S. Const. art. I, § 8; IC 6-2.1-3-3; International Harvester Co. v. Department of Treasury, 322 U.S. 340, 346 (1940); Department of Treasury v. Ingram-Richardson Mfg. Co., 313 U.S. 252 (1940); Ware & Leland v. Mobile County, 209 U.S. 405 (1908); Indiana Creosoting Co. v. McNutt, 5 N.E.2d 310, 312 (Ind. 1930); State of Indiana Dept. of Revenue v. Apex Steel and Supply, Inc., 375 N.E.2d 598 (Ind. App. 1978); 45 IAC 1.1-2-5(a); 45 IAC 1.1-2-5(d); 45 IAC 1.1-3-3(a).

The taxpayer protests the auditor's determination that the taxpayer derived its gross income from the performance of industrial processing rather than, as the taxpayer maintains, from the manufacture of plastic products. The taxpayer maintains that, as a manufacturer of plastic products, it was entitled to claim the Interstate Commerce Clause exemption for gross income derived from sales not completed in Indiana.

II. Abatement of Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(a)(3); IC 6-8.1-10-2.1(b)(2), (4); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer protests the assessment of the 10% negligence penalty and requests that the penalty be abated. The taxpayer maintains that its failure to pay the assessed gross income tax was due to reasonable cause and not due to willful neglect.

Statement of Facts

The taxpayer is engaged in the processing of raw plastic materials at its Indiana facility. The taxpayer's activity involves the processing of raw plastic materials, supplied by the taxpayer's customers, for which the customer is charged a processing fee as well as additional charges for various additives and pigments consumed during the processing.

Most of the raw plastic materials are shipped to the taxpayer's facility in especially designed rail cars. The taxpayer invoices, where applicable, a separate charge for the unloading of each customer's plastic materials. The plastic material provided by taxpayer's individual customers is not fungible. The plastic material supplied by customer "A" is processed and returned to customer "A" and is not intermingled with or exchanged with the plastic material supplied by customer "B." Additionally, the taxpayer bears the risk of loss or damage for each customer's raw materials. If an error is made in the processing of the customer's raw plastic material or if the finished material does meet the customer's specifications, the taxpayer reimburses the customer and retains possession of the damaged raw material until it can be resold to an alternate customer.

DISCUSSION

I. Whether Taxpayer is a Manufacturer Entitled to Claim Exemption From the Gross Income Tax Under the Interstate Commerce Clause.

The taxpayer has protested the auditor's determination that it was "engaged in providing industrial processing services." The taxpayer maintains that it is in the business of performing work which constitutes manufacturing. The significance in the distinction is that, as a manufacturer, the taxpayer would be entitled to claim the Interstate Commerce Clause exemption for income derived from sales to its out-of-state customers.

The auditor determined that the taxpayer was performing a service because it was processing customer-owned raw plastic stock and returning the identical stock to the customer. The auditor characterized taxpayer's activity as performing services, within Indiana, that fell within the requirements for treatment as industrial processing.

The code section upon which the taxpayer predicates its claim is found at IC 6-2.1-3-3 which states, "[g]ross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution." The code section is an indirect reference to the limitations placed upon the individual states by the Interstate Commerce Clause. U.S. art. I, § 8. 45 IAC 1.1-3-3(a) complements the code section and states that "[g]ross income derived from business conducted in interstate commerce is exempt from the gross income tax to the extent such taxation is prohibited by the United States Constitution."

It is not disputed that the taxpayer contracts with out-of-state companies to process the companies' raw plastic, that the out-of-state companies ship their plastic material into Indiana, and that, upon completion, the customer's finished plastic is returned to the originating state. While the particular details surrounding the taxpayer's operations are important, "[i]n determining whether commerce is interstate or intrastate, regard must be had to its essential character." Indiana Creosoting Co. v. McNutt, 5 N.E.2d 310, 312 (Ind. 1930) citing Pennsylvania R.R. Co. v. Clark Coal Co., 238 U.S. 456, 465-66 (1915). In particular, the United States Supreme Court has held that the Commerce Clause does not prohibit the state from imposing a tax on the proceeds of an otherwise interstate

transaction as long as a "local transaction is made the taxable event and that event is separate and distinct from the transportation or intercourse which is interstate commerce." International Harvester Co. v. Department of Treasury, 322 U.S. 340, 346 (1940).

The Indiana Gross Income tax may be constitutionally imposed on income derived from the performance of a service in Indiana. The performance of a service, with or without the incidental furnishing of tangible personal property, on goods belonging to others is taxable if it takes place in Indiana regardless of whether the property moved in interstate commerce before or after the service was provided. Department of Treasury v. Ingram-Richardson Mfg. Co., 313 U.S. 252 (1940). In State of Indiana Dept. of Revenue v. Apex Steel and Supply, Inc., 375 N.E.2d 598 (Ind. App. 1978), the court defined "servicing" as "performing some act upon a material in order to render it in a condition for further use, or sale or into a finished state. Id. at 600.

The Department's own regulations reflect the precedents set by these cases and the principles thereby established. In regard to the concerns raised by the taxpayer, 45 IAC 1.1-2-5(a) specifically addresses those issues when it states that "[g]ross income derived from the provision of a service of any character within Indiana is subject to the gross income tax. This is true even when a service contract calls for the furnishing of tangible personal property in the performance of the contract." 45 IAC 1.1-2-5(d) further explains that "[g]ross income derived from the provision of a service within Indiana, with or without the incidental furnishing of tangible personal property, *on goods belonging to another*, is subject to the gross income tax even though such property is moved in interstate commerce before or after the performance of the service." (Emphasis added).

However, even if the taxpayer's activities could not be properly characterized as services, it is clear that the taxable events, at issue here, occur entirely within the state of Indiana and are subject to the state's gross income tax because the performance of the contract occurs entirely within Indiana. The United State Supreme Court in Ware & Leland v. Mobile County, 209 U.S. 405 (1908) stated that, "Contracts between citizens of different states are not subjects of interstate commerce simply because they are negotiated between citizens of different states . . . when the contract itself is to be completed and carried out wholly within the border of a state, although such contracts incidentally affect interstate trade."

The taxpayer receives gross income from various services, performed at its Indiana situs, for its out-of-state customers. These services are performed entirely within the state of Indiana. No transfer of title to the raw material occurs but rather, title remains always within the possession of the customer. The Indiana activities are related to the critical transaction. Taxpayer's services are more than minimally related to the substance of the transaction and are not remote or incidental to the total transaction. The taxpayer may find it "inconceivable" that as an owner of a facility containing 20 million dollars worth of production equipment it "would not be considered a manufacturer" (Taxpayer Letter, Aug. 20, 1997) but the "essential character" of what taxpayer performs consists of accepting the customer's plastic material, processing that material, and returning that

same material to the individual customer – a most worthwhile service, but nonetheless, a service. "The evidence and the contract in the instant case clearly show that work or service done by the appellant . . . was exclusively a local and intrastate business, and not interstate; and, therefore, the appellant is not exempt from the Gross Income Act." Indiana Creosoting, 5 N.E.2d at 313.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of Ten-Percent Negligence Penalty.

The taxpayer has requested that the ten-percent negligence penalty, assessed under the authority of IC 6-8.1-10-2.1, be abated. IC 6-8.1-10-2.1(a)(3), imposes on the taxpayer a penalty for "a deficiency that is due to negligence." The penalty is limited to ten-percent of the amount of the tax that was not timely remitted. IC 6-8.1-10-2.1(b)(2), (4). The standards under which negligence is determined and the penalty imposed is found at 45 IAC 15-11-2(b) which states that "'[n]egligence' on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to the duties placed upon the taxpayer by the Indiana Code or department regulations." The regulation goes on to state that the Department shall determine negligence "on a case by case basis according to the facts and circumstances of each taxpayer." Id.

The Department is authorized to waive the penalty "if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). The regulation provides a non-exclusive list of factors, which go toward establishing reasonable cause, but concludes that "[r]easonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case. Id.

In its defense and in an attempt to affirmatively establish the reasonable cause necessary to justify abatement of the penalty, taxpayer argues that there is "nothing in Indiana case law or department published material to give guidance." Taxpayer Protest Letter, Sept. 8, 1999. From the above discussion, it would appear that the taxpayer is mistaken. In the absence of a more substantive reason to justify abatement of the penalty, the Department must decline the opportunity to do so.

FINDING

Taxpayer's protest is respectfully denied.